ORIGINAL

Application of Carolina Water Service, Inc. for approval of an increase in its rates for water service for all its service areas and for sewer service for certain of its service areas.

Docket No. 2000-207-W/S

POSTED 6/28/01

Testimony of
Sharon G. Scott
Audit Department

Public Service Commission of South Carolina

TESTIMONY OF SHARON G. SCOTT
FOR
THE PUBLIC SERVICE COMMISSION OF SOUTH CAROLINA
DOCKET NO. 2000-0207-W/S
IN RE: CAROLINA WATER SERVICE, INC.

Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS AND OCCUPATION.

A. My name is Sharon G. Scott. My business address is 101 Executive Center Drive, Columbia, South Carolina. I am an Auditor for the Public Service Commission of South Carolina.

Q. PLEASE STATE YOUR EDUCATIONAL BACKGROUND AND YOUR BUSINESS EXPERIENCE.

A. I received a B.S. Degree in Business Administration, with a major in Accounting from the University of South Carolina in May 1983 and a MBA degree from Webster University in May 2000. I was employed by this Commission in July 1983, and have participated in cases involving gas, electric, telephone, and water and wastewater utilities. I have 18 years of auditing experience.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY INVOLVING CAROLINA WATER SERVICE, INC?

A. The purpose of my testimony is to set forth, in summary form, the Staff's findings and recommendations resulting from our review of the Company's application in this docket. These findings and recommendations are set forth below and in the report of the Audit Department with attached exhibits.

Q. I SHOW YOU THIS DOCUMENT. WOULD YOU IDENTIFY IT PLEASE?

A. This is the "Public Service Commission of South Carolina, Commission Staff Report, Carolina Water Service, Inc. Docket No. 2000-0207-W/S, Application for Rate Increase."

Q. DID YOU PREPARE, OR CAUSE TO BE PREPARED UNDER YOUR DIRECTION AND SUPERVISION, A PORTION OF THIS DOCUMENT?

A. Yes, with the exception of that portion which is tabbed Utilities Department, I prepared the report with assistance from the Audit Department Staff.

Q. (MARK FOR IDENTIFICATION). NOW WOULD YOU EXPLAIN THE CONTENTS OF THIS REPORT?

A. As outlined in the Index of Staff's report, the first 5 pages contain the report's analysis. The remaining pages consist of exhibits which were prepared to show various aspects of the Company's operations and financial position. The major portion of my testimony will refer to Audit Exhibit AC, Operating Experience, Rate Base, Rate of Return and Operating Margin for the test year ending December 31, 2000 on a per book and as adjusted basis for Combined Operations as shown on page 6 of the Staff's report. Rate of Return and Operating Margin for Water and Sewer Operations are shown on Exhibits AW and AS, respectively. Staff prepared this exhibit in compliance with the Commission's standard procedures for Water and Wastewater utility rate increases.

Q. WOULD YOU EXPLAIN THE FORMAT OF EXHIBIT AC, AW, and AS?

A. Column (1) shows the Company's per book balances as of December 31, 2000. Staff verified the per book balances to the Company's books and records.

Column (2) shows the Staff's accounting and pro forma adjustments designed to normalize the Company's per book operations.

Column (3) shows Staff's computation of the Company's normalized test year prior to giving effect for the proposed increase.

Column (4) shows the Staff's adjustments for the proposed increase as furnished by the Utilities Department and the adjustments associated with the additional revenue.

Column (5) shows the Staff's computation of the normalized test year after the accounting and pro forma adjustments and the effect of the proposed increase and its associated adjustments.

Q. WOULD YOU PLEASE ELABORATE ON THE CALCULATIONS IN EXHIBIT AC, AW, and AS ?

A. Amounts shown for Combined Per Book operations were verified to books and records of the Company during Staff's examination with the exception of Customer Growth and Cash Working Capital which are shown as Exhibits A-2 and A-3, respectively. For Combined operations Staff computed a Rate of Return on Rate Base Per Books of 8.12% and an Operating Margin of 6.27%. For Water Operations, Staff computed a Rate of Return on Rate Base Per Books of 9.79% and an Operating Margin of 11.05%. For Sewer Operations the Rate of Return on Rate Base Per Books is 7.34% and Operating Margin is 4.02%. After accounting and pro forma adjustments, the Rate of Return on Rate Base is 8.29% for Combined Operations, 10.39% for Water Operations and 7.40% for Sewer Operations. Operating Margin as adjusted is 9.30% for Combined Operations, 13.31% for Water Operations, and 7.42% for Sewer Operations. The Company is requesting additional gross annual revenues of $685,063 or an increase of $210,948 for Water and $474,115 for Sewer. After the requested increase, Staff computed a Return on Rate Base of 12.01% for Combined Operations, 14.21% for Water Operations and 11.07% for Sewer Operations. The Operating Margin after the requested increase is 15.80% for Combined Operations, 19.14% for Water Operations, and 14.24% for Sewer Operations.

Q. WOULD YOU PLEASE EXPLAIN THE ACCOUNTING AND PRO FORMA ADJUSTMENTS IN EXHIBIT A-1?

A. Yes, Staff has made accounting and pro adjustments for known and measurable changes to test year operations. These adjustments are shown on Audit Exhibit A-1, and are designated as either (U) Utilities Department or (A) for Audit Department. My testimony will address those adjustments designated as (A).

Adj. # 1 Operator's Salaries- The Staff and Company propose to annualize the operators' salaries for the test year. Staff annualized the payroll at 12-26-2000 for total annualized wages of $718,071. From this amount, Staff subtracted per book wages of $696,527 resulting in Staff's adjustment for annualized wages. Staff capitalized a portion of the annualized wages representing the time operators spend on capital projects. Staff capitalized 20.87% or $4,496 of the wage adjustment and expensed $17,048. Staff's wage capitalization rate is based on the actual wages capitalized per books. Staff computed payroll taxes of $1,575, of which $329 was capitalized, and pension and other benefits of $1,373 of which $287 was capitalized. Staff's total expense adjustment is $18,134, consisting of wages of $17,048 pension and benefits of $1,086. The Company annualized salaries using year-end payroll less per book wages for an adjustment of $64,371. Staff computed pension and benefits of $10,898 and payroll taxes of $7,555. The Company's annualization included 1 ½ vacant operator positions. The Company did not propose to capitalize operator's salaries.

Adj. #2 – Office Salaries – The Staff and Company propose to annualize office salaries. Staff annualizes the year-end payroll totaling $94,950. From this amount, Staff subtracted the per book amount of $98,164 for a net adjustment of ($3,214). Staff also reduced payroll taxes by ($246) and pension and benefits by ($735.) Staff adjusted G & A expenses for the wage adjustment of ($3,214) and pension and benefits of ($735) totaling ($3,949). The Company annualized wages using the 12-26-2000 payroll and subtracted per book wages. However, the Company's adjustment of $15,216 included the annualized salary of 1 terminated employee. The total office salaries are booked to General and Administrative Expenses.

Adj. #3 – Employee Bonuses – The Staff proposes to remove bonuses for CWS and WSC employees. Full time employees received a bonus of $100 and part-time employees received $50. Staff removed $2,381 for bonuses for CWS employees and WSC bonuses allocated to CWS of $136, which included FICA expense.

Adj. #4 – Update Customer Equivalents - The Staff proposes to adjust common expenses, direct salaries, Charlotte warehouse, Charlotte office, and the Columbia office for customer equivalents updated to 12-31-2000. Staff recalculated the allocation factors and applied the factors where applicable in the allocation process. As a result, Operating and Maintenance expenses decreased by ($10,665), General and Administrative Expenses by ($753), Depreciation and Amortization by ($351) and Taxes Other Than Income by ($845).

Adj. #5-Rate Case Expenses – The Staff and Company propose to adjust for rate case expenses. Staff's adjustment includes the recomputed executive salary of $14,029 using a base salary rate excluding bonuses and actual time spent on the rate case. Staff included actual legal fees of $21,557, rate case notices, postage, and envelopes of $5,995. Staff amortized total expenses of $42,087 over a three-year period, for a total adjustment of $14,029. Staff used a three-year amortization period which has been consistent with the past amortization periods used by this Commission. Staff is of the opinion that a 3-year period is adequate time to recover rate case expenses and Staff found no reason to use a different amortization period in this case. The Company proposes to amortize estimated rate case expenses of $188,200 over three years for a total adjustment of $62,733. The Company's adjustment included mostly estimated expenses - legal fees of $100,000, travel of $2,600, executive salaries of $65,600, and the expense for cost of capital witness of $20,000, for a total cost of $188,200, amortized over three years.

Adj. # 6 – Deferred Expenses – The Staff proposes to adjust Deferred Charges to reflect allowable expenses, which are those expenses unanticipated and non-recurring. This adjustment is made in accordance with the SC Supreme Court Case in Docket No. 93-738-W/S. Staff removed expenses for tank maintenance for water operations, pressure washing and jetting sewer mains, TV camera for sewer mains, and regulatory expenses which were unrelated to CWS. The unrelated regulatory expenses included items which should have been booked to Utilities, Inc. Staff included Attorney fees for Lake Murray Bulk Water Agreements of $2,087, the I & I study of $8,674 and expenses associated with various regulatory matters which include the Erwin Complaint, Bulk Rate issues, Rate Case Appeal of 1998, issues with The Landings and Clover School District, totaling $271,187. Staff amortized these expenses over 5 years for a total amount of $56,390. Staff subtracted the per book amount for Deferred Expenses of $76,706, for a net reduction to the per book numbers of ($20,316.)

Adj. # 7 – Nonallowable Expenses - The Staff disallowed expenses which are considered non-allowable for ratemaking purposes. Staff disallowed direct expenses to CWS which included flowers, a billing error, ½ of Chamber of Commerce dues, and items for which the Company did not provide support. Staff also reclassified telephone and electric services of $192 which were capitalized items that should have been expensed. Total nonallowable direct expenses amounted to $19,479. Staff also disallows WSC common expenses allocated to CWS, which are considered nonallowable for ratemaking purposes. These expenses included out of test year expenses, flowers, ½ chamber of commerce dues, and employee newsletters. Staff also reclassified items which should be capitalized. The total WSC expenses amounted to $12,323, of which CWS was allocated 6.823% or $841.

Adj. # 8 – Depreciation Expense Adjustment – Both Staff and the Company propose to annualize Depreciation Expense. The Staff's adjustment included completed plant of $23,239 added to Gross Plant of $31,616,926. Gross plant was then reduced by Organization Expense - $55,080, Land - $289,237, Vehicles - $303,210, Computers - $50,549, Contributions In Aid of Construction of $14,640,497, Plant Acquisition Adjustment - $820,163, and Advances in Aid of $1,000 for Net Plant of $15,480,429. Staff applied the Depreciation Rate of 1.50% to net plant for total expense of $232,206. Staff then applied a 20% Depreciation rate to vehicles that were not fully depreciated, for a total of $48,626. Staff depreciated Computers using a depreciation rate of 20% amounting to depreciation expense of $10,110 and included depreciation expense associated with the WSC Rate Base of $12,458. Staff recomputed the amortization of Excess Book Value using a 2.50% rate for a total reduction to depreciation expense of $48,448. Staff's Total computed Depreciation amounted to $254,952 less the per book amount of $287,922, resulted in an adjustment of ($32,970). The Depreciation rates used by the Staff were recommended by the Utilities Department. The Company's adjustment included plant additions estimated at $372,950. Gross plant was not reduced for organizational expense and computers before applying the rate of 1.50%. The

Company did not remove fully depreciated vehicles, include WSC Rate Base Depreciation Expense, or reduce depreciation by the amortization of Excess Book Value. Including the amortization of CIAC, the Company's net adjustment amounted to $26,917.

Adj. # 9 – Lease to Bio Tech - The Staff proposes to remove Depreciation Expense associated with Bio Tech, a sister company of CWS which shares the West Columbia Office building. Staff reviewed the lease agreement, and found that Bio Tech leases 4,400 square feet (51%) of the 8,600 square foot building owned by CWS for a term of 5 years, beginning July 18, 1997, for a sum of $5.00 which shall be the entire amount of the rent. Staff proposes to allocate 51% of the depreciation expense to Biotech. Staff did not remove any other operating expenses since Bio Tech is responsible for paying its own expenses such as1/2 real estate taxes, utilities, security system, and repairs and maintenance. Staff verified total gross plant of $487,768 and applied the depreciation rate of 1.50%, amounting to $7,317 of which Bio Tech is allocated 51% or ($3,744.) This amount is removed from depreciation expense.

Adj. #10 – Expenses Associated With River Hills and I-20 and Watergate – The Staff proposes to remove property taxes associated with plant no longer being used in the River Hills subdivision and I-20 and Watergate areas. CWS has bulk water agreements with York County, City of West Columbia, and Lexington County Joint Water and Sewer Commission, to provide water to the above mentioned areas. In these areas, Staff concludes that the wells and other plant items are no longer "used and useful" to provide service to customers since these customers now receive bulk water from the various municipalities. Staff proposes that such expenses associated with these areas be removed from operating expenses. Staff requested that the company identify the expenses associated with these systems. The Company stated that there were no operating, maintenance, or other expenses for water or sewer plant no longer being used included in the test year expenses with the exception of taxes on wells. The Company provided a computation for the taxes based on the fair market value (FMV) of wells of $4,609. In River Hills, there are 3 wells no longer being used to supply water, thus totaling $13,827. The company's property valuation in York County is $1,555,048 and taxes paid during the year was $36,313, thus producing a factor of 2.36% applied to the FMV of $13,827 for River Hills wells, resulting in an adjustment of ($323) for property taxes. In I-20 and Watergate, there are 45 wells no longer being used to supply water, thus totaling a FMV of $207,405. The company's property valuation in Lexington County is $2,361,143 and taxes paid during the year was $84,392, producing a factor of 3.57% applied to the FMV of $207,405, resulting in an adjustment of ($7,413) for property taxes for I-20 and Watergate wells. Staff also computed depreciation expense associated with these wells by applying the depreciation rate of 1.50% to the depreciable plant. The total depreciable plant for River Hills and I-20 and Watergate amounted to $439,406, for a total of ($7,401) for depreciation expense. It is noted that this information, as supplied by the Company is unaudited, but was reviewed and recomputed by the Staff.

Adj. #11 – Gross Receipts Tax Increase - The Company proposes to increase gross receipts taxes by 5%. Staff was unable to verify the Company's increase, but used the most current gross receipts factor to account for the changes in revenue.

Adj. #12 – Income Taxes - The Staff and the Company propose to adjust for the effect of income taxes after accounting and pro forma adjustments. Both Staff and Company use a 5% rate for state taxes and a 34% rate for federal taxes. Staff includes operating revenues less operating expenses and allowable interest expense of $494,278 to compute as adjusted Income Taxes of $251,972. Staff's adjustment is As Adjusted Income Taxes less per book taxes of $142,189. The Company's adjustment for state and federal taxes totals ($440) reduction to per book taxes.

Adj. #13 – Interest on Customer Deposits – The Staff proposes to annualize Interest on Customer Deposits by using the account balance at 12-31-2000 of $159,022 and applying the Commission approved interest rate of 8%. Staff computed annualized Interest on Customer Deposits of $12,722 less the per book amount of $12,910 for an adjustment of ($188).

Adj. #14 – Allowance for Funds Used During Construction (AFUDC) – The Staff and Company propose to remove the income associated with capitalized interest on projects under construction. The AFUDC is allowed as an offset to the Interest capitalized when the plant is under construction. The Company proposes to remove the total AFUDC of $17,478. Staff proposes to remove only the AFUDC associated with plant items which have been closed to plant in service. Staff verified the

AFUDC associated with the closed projects and proposes to remove ($3,147) from AFUDC.

Adj. #15 – Capitalized Wages and Benefits – The Staff proposes to capitalize wages associated with the annualization of the operators' salaries. Staff capitalizes 20.87% of the wages and benefits which amounts to $5,112. Staff's capitalization ratio is based on actual wages capitalized during the test year.

Adj. #16 – Officers' Bonuses and Salary Increases - The Staff proposes to remove bonuses and officers' salary increases from capitalized wages. Staff recomputed the capitalized salary rates of 2 officers of Water Services Corporation who charged time directly to CWS. The recomputed rate only includes the base salary, payroll taxes, pension and benefits. Staff computed total capitalized salaries of $51,562 less per book salaries of $95,458 for a total adjustment of ($43,896.) Staff also proposes to disallow officers' test year salary increase of 3%. Staff reduced the base salary rates by 3%, for officers' salary increases, for a total reduction of ($1,502).

Adj. #17 – Plant Sample Items – CWS – The Staff proposes to disallow test year plant additions of ($8,661) for which the Company was unable to provide support. Staff also reclassified ($192) for items which should be expensed.

Adj. # 18 – Plant Sample Items – WSC – The Staff proposes to allocate a portion of expenses which should have been capitalized. Staff removed $3,587 from WSC's expenses for a mailing machine and allocated 7.10% to CWS, amounting to $255. The Staff allocated the WSC expense using the WSC rate base allocation composite factor of 7.10%.

Adj. #19 – Plant Additions – The Staff and Company propose to adjust for plant additions. Staff verified a total of $23,239 for completed plant additions. Additions included $9,913 for installing diffused aeration at the Pocalla Water and Wastewater Treatment Plant and an upgrade to the lift station in River Hills subdivision of $13,326. Staff transferred the lift station from Construction Work in Progress and added the Pocalla project to plant in service.

Adj. # 20 – Water Services Rate Base - The Staff proposes to adjust the WSC Rate Base allocated to CWS. Staff verified the rate base to WSC's books and records and removed deferred charges of $40,526 and adjusted Accumulated Deferred Income Taxes. Staff allocated WSC's rate base based on updated customer equivalents for the total WSC Rate Base allocated to CWS of $150,190. Per Book rate base amounted to $158,647 resulting in a total adjustment of ($8,457).

Adj. No. 21 – CWS Building Lease to Bio Tech – The Staff proposes to allocate a portion of CWS plant associated with the business office in West Columbia. CWS owns the building and has leased it to Bio Tech for 5 years for a total of $5.00 for the lease term. Bio Tech occupies 51% or 4,400 square feet of the total 8,600 square feet building. Staff removed 51% of the office building of $487,786, amounting to ($249,565) and removed 51% of Accumulated Depreciation of $217, 876 amounting to $111,471.

Adj. # 22 – Plant Associated Bulk Water Agreements – The Staff proposes to remove plant and accumulated depreciation associated with areas now being served by bulk water agreements. Staff considers the plant no longer "used and useful" since the customers in these areas are now receiving water from other sources. The Company supplied the Staff with the computation of the amount of water plant in areas where customers receive bulk water. The Company's computation used actual water plant in service less Accumulated Depreciation, Purchase Acquisition Adjustment, CIAC, and Accumulated Deferred Income Taxes to compute net plant to be allocated. The Company then computed a factor using water customers for the respective areas, as a percentage of total water customers. For I-20 and Watergate, total customers amounted to 2,759 and total water customers are 6,190 for an allocation factor of 44.57%. This factor is applied to water plant of $427,488, and reduced by Excess Book Value of ($19,207), for total plant associated with wells in the I-20 and Watergate of ($171,333.) For River Hills, total customers amounted to 1,867 and total water customers are 6,190 for an allocation factor of 30.16%. This factor is applied to water plant of $427,488, and reduced by Excess Book Value of ($12,151), for total plant associated with wells in the River Hills area of ($116,786.) Staff's total adjustment is ($288,119). The Company ascertains that this customer allocation to identify plant that is no longer "used and useful" is the best information available since the Company does not maintain records by subdivision due to the age of the systems.

Adj. # 23 – Accumulated Depreciation - The Staff proposed to adjust accumulated depreciation to correspond to Staff's adjustment for annualized depreciation. Staff computed a reduction to depreciation expense of $32,970. The Staff reduces Accumulated Depreciation by this amount.

Adj. #24 – Cash Working Capital – The Staff and Company propose to adjust CWC for Staff's adjustments to O & M expenses which correct the books, such as removing nonallowables, etc. Staff's adjustment amounted to ($6,051) and Company's adjustment amounted to $19,241. Staff also notes that the Company used Taxes Other Than Income in computing Cash Working Capital. Staff does not include this expense since it is normally an accrual not requiring a cash outlay and the Company would have collected from its customer's funds in advance of paying certain taxes.

Adj. #25 – Interest On Customer Deposits - The Staff proposes to adjust for Interest on Customer Deposits. The Company booked accrued interest of in a separate account, and Staff proposes to reduce Rate Base by the Interest of ($219,269) owed to the customer.

Adj. #26 – Proposed Increase - Staff and Company propose to adjust for the effect of the proposed rates and charges. Staff and Company propose to include service revenues of $685,063 for combined operations, $210,948 for water and $474,115 for sewer operations. The Staff and Company propose to adjust for uncollectible revenue associated with the proposed revenues using the uncollectible factors for the test year of .57% for water and .59% for sewer. The Staff examined the uncollectible rates for the previous four years and found this rate to be comparable. Staff's and Company's differences for the Gross Receipts adjustment are due to rounding. Staff and Company computed gross receipts taxes associated with the proposed revenue using the most recent gross receipts factor of .011868167. Staff and Company computed Income Taxes associated with the proposed increase. Staff computed Customer Growth associated with the increase of $3,999, as shown on Exhibit A-2.

Q. MS. SCOTT, ARE YOU AWARE THAT IDLEWOOD AND WESTSIDE TERRACE SUBDIVISIONS HAVE ASKED THIS COMMISSION FOR APPROVAL OF BULK WATER AGREEMENTS?

A. Yes, I am.

Q. HAVE YOU COMPUTED THE IMPACT OF REMOVING THESE SUBDIVISIONS FROM EXPENSES AND RATE BASE?

A. Yes, I have. While Staff has taken no position on the removal of the Idlewood and Westside Terrace subdivisions from expenses and rate base, I have computed the impact of removing these subdivisions from expenses and rate base. In computing the impact of removing these subdivisions from expenses and rate base, Staff used the same method used to compute the removal of the expenses and plant from River Hills, I-20, and Watergate service areas. For Idlewood and Westside Terrace subdivisions, total customers amounted to 161 and total water customers are 6,190 for an allocation factor of 2.60%. This factor when applied to net water plant for wells of $427,488, results in total plant associated with wells in the Idlewood and Westside Terrace subdivisions of $11,115. Associated adjustments, as computed by Staff, would include elimination of associated property taxes of $823 and Depreciation of $167. Removal of the Idlewood and Westside Terrace subdivisions would increase Return on Rate Base for combined operations from 12.01% to

12.02% and would produce a Return on Common Equity for combined operations from 15.41% to 15.44% for combined operations.

Q. HAS THE STAFF COMPUTED A RETURN ON COMMON EQUITY FOR CAROLINA WATER SERVICE?

A. Included as Audit Exhibits AC-5, AW-5, and AS-5 is Return on Common Equity for Combined Operations, Water Operations, and Sewer Operations, respectively. Staff has utilized the parent company, Utilities, Inc.'s capital structure and embedded cost of Long-Term Debt at December 31, 2000. Staff has computed Return on Common Equity on adjusted operations of 7.96 for Combined Operations, 12.16% for Water Operations, and 6.17% for Sewer Operations. After the requested increase, the Return on Common Equity computed by Staff for Combined Operations is 15.41%, 19.83% for Water Operations, and 13.52% for Sewer Operations.

Q. WHAT ARE THE REMAINING EXHIBITS CONTAINED IN THE REPORT?

A. Exhibit A-2 - Customer Growth Computation.

Exhibit A-3 -Cash Working Capital Allowance.

Exhibit A-4 - Computation of Income Taxes.

Exhibit AC- 5 - Return on Common Equity-Combined

Exhibit AW-5 - Return on Common Equity-Water

Exhibit AS-5 - Return on Common Equity-Sewer

Exhibit A-6 - Income Statement

Exhibit A-7 - Balance Sheet

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.